Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Florez	Analyst:	Colin Stevens	Bill Number:	AB 1610
Related Bills:	See Legislative History	Telephone:	845-3036	Introduced Date:	2/26/99
		Attorney:	Doug Bramhall	Sponsor:	

SUBJECT: Marginal Oil Well Production Credit

SUMMARY

Under the Personal Income Tax Law (PITL) and the Bank and Corporation Tax Law (B&CTL), this bill would allow a credit equal to an unspecified amount per barrel of crude oil produced from marginal wells located in this state, up to a maximum production of 1,095 barrels of crude oil per well. The amount of credit allowed per barrel of oil would be based on the price of California crude oil of a certain specific gravity, as posted by specified refineries.

EFFECTIVE DATE

As a tax levy, this bill would take effect immediately and would apply to taxable or income years beginning on or after January 1, 1999.

LEGISLATIVE HISTORY

SB 38 (Stats. 1996, Ch. 954) enacted the enhanced oil recovery credit, SB 1788 (1998) would have excluded from income certain oil or gas production: Failed passage, AB 687 (1999) would allow additional percentage depletion deductions to independent producers: Assembly Revenue and Taxation Committee.

BACKGROUND

According to the Department of Conservation, Department of Oil and Gas (DOC), California is the nation's fourth largest producer of crude oil, with approximately 45,000 oil and gas wells currently operating, and a production of 340.4 million barrels of oil and 210.2 billion cubic feet of associated natural gas in 1997. According to the DOC, Kern River 13 degree American Petroleum Institute (API) specific gravity oil is the benchmark for the state (approximately two-thirds of crude oil produced in California is Kern River 13 Degree crude). A barrel of oil is defined as having 42 gallons of oil.

SPECIFIC FINDINGS

Federal and state laws allow a variety of special tax credits and deductions designed to promote or influence specific taxpayer behavior believed to generate social or economic benefits for the general public. Included in state and federal law are tax incentives designed to promote business, such as credits for research and development, purchasing manufacturing equipment and for enhanced oil recovery (EOR).

Board Position:			Department Director	Date
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Many **state and federal credits** allow a carry forward of credits that cannot be entirely used in the year generated. In recent years many state credit carryover periods have been limited to a period of seven to ten years. **State credits** have not been allowed to be carried back to be applied against prior years' tax liability.

Federal and state laws allow taxpayers an EOR credit based on costs connected to a qualified EOR project that involves the application of a tertiary recovery method, which is expected to result in a significant increase in the amount of crude oil recovered. The federal credit is 15% of the taxpayer's qualified EOR costs, which are defined as amounts paid or incurred for qualifying tangible property that is depreciable or amortizable and an integral part of a qualified EOR project, qualifying tertiary injectant costs, and qualifying intangible drilling and development costs. **Federal law** provides various rules regarding eligibility for the EOR credit and interaction with other tax provisions.

The **state EOR credit** conforms to the federal rules with specific modifications. The state EOR credit amount is equal to one-third of the credit allowed under federal law. The state EOR credit specifies that the credit may not be claimed if the taxpayer does not qualify for a specified depletion allowance under federal law. Essentially, retailers, certain related parties, and refineries whose output exceeds 50,000 barrels on any day of the year are excluded. A taxpayer must elect on the original return to have this section or another code section apply if costs of property qualify for any other credit. Any excess credit may be carried over for up to 15 years. The state EOR credit may not reduce the tax below tentative minimum tax for alternative minimum tax (AMT) purposes.

Existing state law provides for AMT to ensure that no taxpayers with substantial economic income avoid all tax liability by using exclusions, deductions, and credits (tax preference items). The corporate rate is rate of 6.64% for income years beginning on or after January 1, 1997, while the PITL rate is 7% for taxable years beginning on or after January 1, 1996.

This bill would allow a credit equal to an unspecified dollar amount per barrel of crude oil produced in this state for qualified crude oil production from a marginal well. The dollar amount per barrel of oil would be based on the average monthly wellhead price of 13 degree gravity crude oil posted by Chevron, Texaco, Mobil and Tosco. The posting price of such oil would be deemed to be the average posting price throughout California.

The amount of qualified crude oil production per well could not exceed 1,095 barrels per year, which limitation is specifically adjusted for short taxable years by dividing the number of days in such year by 365 and multiplying the result by 1,095 barrels. The credit would be allowed at unspecified amounts for oil prices ranging from $7 or less to $11.01 or more per barrel. For calendar years after 2000, the price per barrel would be indexed for inflation according to a calculation provided in the Internal Revenue Code.

The credit could only be claimed by a holder of an operating interest in a marginal oil well. In the case where more than one owner has an operating interest in a qualified well, the taxpayer's credit would be determined based on the taxpayer's proportionate interest in the revenue produced from that well.

For purposes of this bill:

- "qualified crude oil production" would be limited to crude oil produced from a marginal well located in California;
- A "marginal well" is a well that has marginal production, as defined, produced from either a stripper well property or from property for which substantially all oil produced during the calendar year is heavy oil (crude oil having a weighted average gravity of 20 degrees or less API, corrected to 60 degrees Fahrenheit).
- Crude oil would mean either natural gas or oil recovered from a well.

The credit could be applied to reduce tax below the TMT for AMT.

The credit could be carried back for up to three years to be applied against prior years' tax liability and could be carried forward for up to 15 years.

Policy Considerations

Although federal law allows a carry-back of certain credits and deductions, such as the business credit or net operating and casualty losses, state law has not allowed carry-backs. This bill would allow a taxpayer to carry back a credit for up to three years, which is unprecedented under state law.

Since this bill could provide a tax benefit for the three years prior to 1999, years in which tax benefits will have already vested by the time this bill could be enacted, it may be considered a gift of public funds and may be held to be unconstitutional without the addition of public purpose language.

The tax credit does not contain a sunset date. Sunset dates generally are provided to allow periodic review of credits by the Legislature.

AMT was created to ensure that taxpayers pay a certain amount of tax. Since this credit would allow regular tax to be reduced below the TMT for AMT purposes, some taxpayers qualifying for the credit may pay no tax.

Credits are typically allowed as a percentage of expenses that the taxpayer has paid or incurred. While the taxpayer will have incurred expenses to produce the crude oil, the credit amount is based on prices established by specified private businesses rather than by reference to the taxpayer’s actual expenses of production or extraction.

Implementation Considerations

The amount of credit allowed by this bill is defined in part by the term “qualified crude oil production.” That term is defined in two places in the bill, subdivision (b)(3) and subdivision (c). If the author intends these two provisions to apply simultaneously, the provisions in subdivision (c) should be merged into the definition in (b)(3).

The provision allowing for a carry-back of credits would require the department to process amended returns and to change its forms and systems for prior years to accept the credits carried back. The costs attributable to the system programming costs are identified below in costs. Additionally, carry-back provisions would introduce additional complexity both in preparing tax returns and for the department in auditing those returns.

To properly implement this bill, the department will need clarification on the actual calculation of the credit. For example, the credit could be calculated based on the average monthly price of oil, determined by adding the average price for each of the 12 months during the year, then dividing by 12, and multiplying the appropriate dollar price figure by the number of qualifying barrels. Or it could be calculated by multiplying the number of qualified barrels of production in a given month by the appropriate dollar price figure for that month. The actual credit figure for the year would then be determined by adding the credit amount allowed over each of 12 months. Moreover, it is unclear where department staff would get the information to verify the average Kern River posting price for the California refineries. If this information is not published, the department would incur costs to compile the information in order to verify the average posting price.

Currently, tax rates and other tax items such as the standard deduction are indexed for inflation based on consumer price index (CPI) information provided by the Department of Industrial Relations. This bill instead would require the department to index based on federal CPI adjustments, which may be different from California CPI. The calculation also would be different from the federal reference price for oil.

Technical Considerations

The average monthly posted price for Kern River 13 degree gravity crude oil would be deemed to be the average wellhead price posted by four specified refineries. Although it is likely that this would be for production only in California, the bill does not so specify.

In describing a "marginal well," this bill makes reference to various terms in federal law, under IRC Section 613A(c)(6)(D), (E), (F) and (G), such as "marginal production," "stripper well property" and "heavy oil." The bill also writes similar yet slightly differently worded definitions in stand-alone form. The bill would be clearer if it either contained entirely stand-alone language or adopted the applicable federal definitions with any modifications necessary to accomplish the author's objectives.

In describing a “marginal well” and “crude oil,” the bill makes reference to a “domestic” well and “domestic” crude oil. In describing “domestic” the bill references IRC section 613A(e). That section defines domestic to include any well located within the United States or a possession of the United States. This reference conflicts with the definition of “qualified crude oil production” which limits the application to a marginal well located in California.

The credit provided by the bill is limited to the holder of an “operating interest” in the well. This term is not defined and the lack of definition may lead to disputes between taxpayers and the department. Section 614 of the Internal Revenue Code provides regulations that define an "operating mineral interest," and could be used if that definition meets the author's intent.

Amendments 1 and 2 would make minor technical changes to rewrite subdivision (a), which is awkwardly drafted.

While the DOC is allowed to "recommend" a substitute poster, if any, the bill does not specify whether such recommendation must be adopted in calculating the credit amount. The author's intent regarding substitute poster(s) should be clarified to avoid disputes between taxpayers and the department.

On page 7, lines 21-22, and page 13, lines 21-22, a reference to "the amount" is unclear. Clarification of the author's intent would avoid disputes between taxpayers and the department.

FISCAL IMPACT

Departmental Costs

To implement the carry-back provisions of this bill, the department would incur one-time costs of approximately $260,000 to reprogram the department's computer systems.

These programming changes would be needed since the department's systems do not currently contain this credit for 1996, 1997 or 1998, and significant reprogramming would be required to allow the carry-back to those years. The changes would require significant testing to ensure that changes made to accommodate any credit carry-backs do not adversely affect existing system processes.

Tax Revenue Estimate

It is not currently possible to assign a revenue impact to this bill as the credit rates are not specified.

Tax Revenue Discussion

The revenue impact of this measure would depend on the credit amounts, the monthly oil prices for Kern River 13 degree gravity crude (crude) and the number of qualified barrels produced.

This bill would provide six different credit amounts to be determined by the average monthly price of crude oil. Crude prices may change substantially in a short time. Kern River crude prices averaged about $8 per barrel during 1998. The high was about $11 with a low of about $6.50 per barrel. So far in 1999 Kern River crude prices have fluctuated from a low of about $6.50 to a high of just under $10.

In 1997, California had approximately 300 active oil and gas fields, including offshore leases. These fields produced about 340 million barrels of crude. It is estimated that between two-thirds and 80% of all crude produced in California is produced from marginal wells. About 55% of all

California oil is produced using enhanced oil recovery, i.e. injection of steam, water, or gas into oil reserves.

BOARD POSITION

Pending.

Analyst Colin Stevens
Telephone # 845-3036
Attorney Doug Bramhall

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 1610
As Introduced February 26, 1999

AMENDMENT 1

On page 7, amend lines 34-40 as follows:

(d) In the case of a marginal well in which there is more than one owner of an operating interest in the well, qualifying crude oil production attributable to the taxpayer shall be determined on the basis of the ratio which the taxpayer's revenue interest in the production bears to the aggregate of the revenue interests of all operating interest owners in the production.

AMENDMENT 2

On page 13, amend lines 34-40 as follows:

(d) In the case of a marginal well in which there is more than one owner of an operating interest in the well, qualifying crude oil production attributable to the taxpayer shall be determined on the basis of the ratio which the taxpayer's revenue interest in the production bears to the aggregate of the revenue interests of all operating interest owners in the production.